Nos. 72-3202, 73-1162, 73-1161

United States Court of Appeals
For the Ninth Circuit

Nos. 72-3202, 73-1162

GOLCONDA MINING CORPORATION,
Petitioner/Appellant/Cross-Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent/Appellee/Cross-Appellant.

No. 73-1161

GOLCONDA MINING CORPORATION,
Petitioner-Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

ON APPEAL FROM THE JUDGMENT OF THE TAX COURT OF THE UNITED STATES

OPENING BRIEF FOR GOLCONDA MINING CORPORATION

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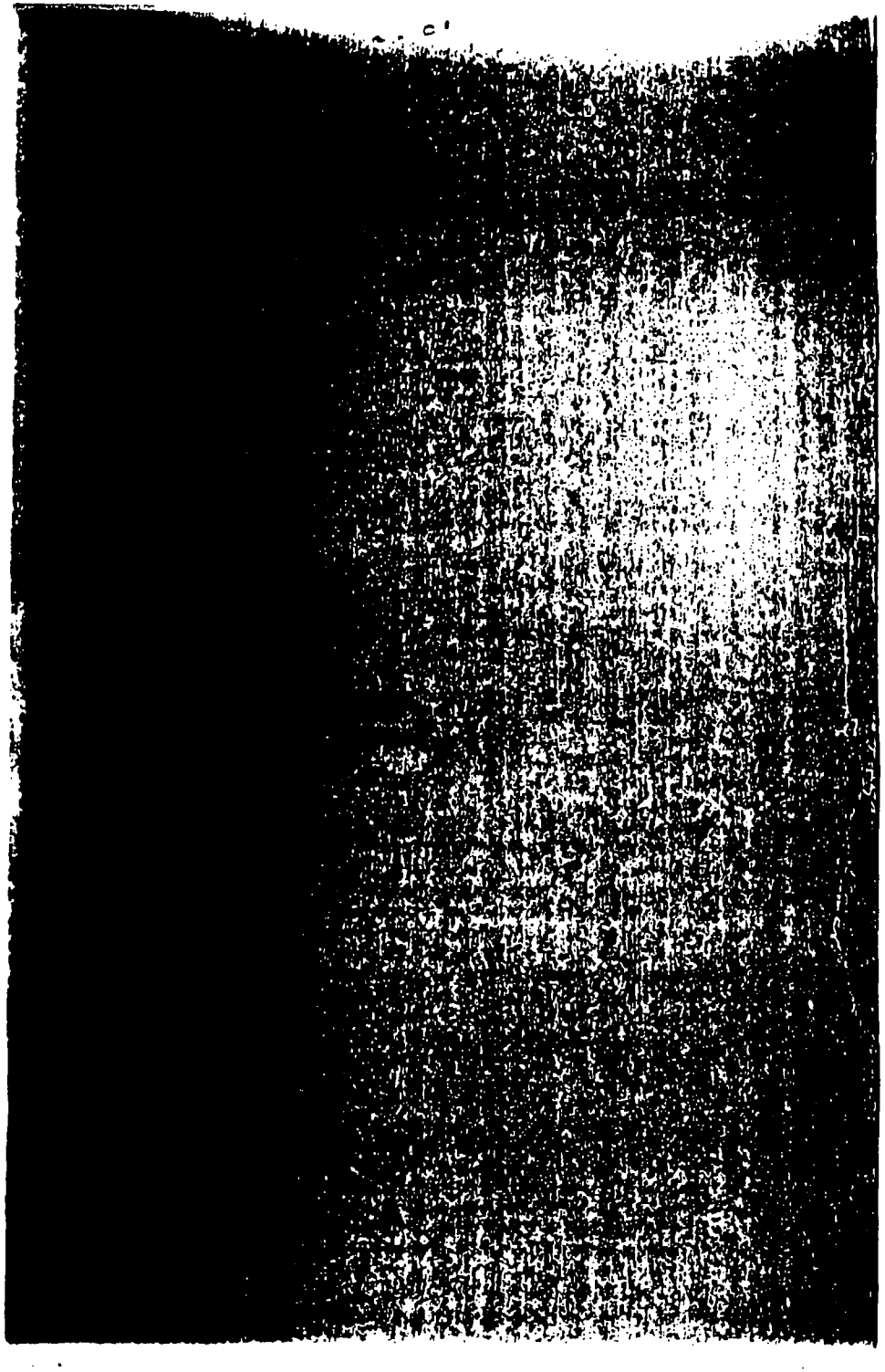

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STATEMENT OF ISSUES PRESENTED FOR REVIEW

A. The appeal of Golconda Mining Corporation (Golconda) in CA No. 72-3202 presents the following issue: Was Golconda subject to the tax on accumulated earnings under IRC §531 for 1966?

B. The Commissioner of Internal Revenue's appeal in CA No. 73-1161 and cross-appeal in CA No. 73-1162 present the same issue for the years 1962 through 1965.

Jurisdiction is conferred on this Court by IRC (1954) Sec. 7482.

STATUTES INVOLVED

The statutes involved are Sections 531, 532, 533, 535 and 537 of the Internal Revenue Code of 1954 as they existed in the period 1962 through 1966. They are reproduced in the appendix, *infra*.

STATEMENT OF THE CASE*

Two separately docketed cases in the Tax Court presented for different years the same issue, namely, whether Golconda Mining Corporation (Golconda) was subject to the accumulated earnings tax under IRC 531 *et seq*. The cases were consolidated for trial and decision. The Tax Court held that Golconda was not subject to the tax in the years 1962 through 1965 but was subject to the tax in the year 1966.

Golconda has appealed the decision on 1966, and the Commissioner has appealed the decision on the years 1962 through 1965. The cases have been consolidated in this Court. This opening brief of Golconda presents its appeal on 1966.

I. History

Shortly after its incorporation in Idaho in 1927, Golconda acquired properties, built a mill and commenced mining in the eastern part of the Coeur d'Alene mining district north of the Osburn fault, between Wallace and Mullan, Idaho (Tr. 86, 88-89). The Coeur d'Alene district

*References "R" are to the transcript of the record in docket Nos. 72-3202 and 73-1162. References "Tr." are to the reporters transcript of the testimony in the Tax Court.

is approximately 30 miles long by 20 miles wide and is one of the principal mining districts in the world, producing 40% to 50% of the nation's silver (Tr. 84). Golconda continued mining until 1956, with net smelter returns of approximately $4,300,000 (Tr. 86-87).

In 1939, John Sekulic took an option on the Lucky Friday claims east of the Golconda property in the Coeur d'Alene area, which he placed in a corporation named Lucky Friday Silver-Lead Mines. He ran out of funds quickly and came to Golconda (Tr. 91-92). Three agreements were made (1940-43) whereunder Golconda performed the mining operations on the property and received stock for its expenditures and advances (Tr. 92; Exh. 116, see Appendix C, p. A-10.)

From the time of these agreements, Golconda was the largest stockholder in and controlled the operations of Lucky Friday (Tr. 97). The Lucky Friday mine gradually developed in depth, and increasing ore was discovered as the mine was sunk down. During this same period of time, other mines in the area also were demonstrating larger ore reserves at depth. Two of the largest mines in the district, the Morning mine and the Star mine, had been sunk to a depth of 4,800 feet and 5,000 feet, respectively, with increasing ore (Tr. 102).

In 1951 Lucky Friday started paying dividends (Tr. 490). Despite the success of Lucky Friday, however, the financial condition of Golconda up to 1956 was at all times short of cash and sometimes desperate. It had a substantial deficit (Tr. 98-99, 484).

The original Golconda mine was primarily a lead mine (Tr. 113) at shallow depth (Tr. 88; Exh. 24X) in a type of

ground which made it a high-cost mine (Tr. 168). The fall in lead prices forced the Golconda mine to close in early 1957 (Tr. 98, 490). After the mine closure, the Golconda mill continued in operation, primarily handling Lucky Friday ore (Tr. 490).

Despite the fact that Golconda had an earned surplus deficit and was suffering a loss for the year, the directors in 1957 decided to institute a program of paying dividends. This was possible because the Idaho law provides that mining companies can pay dividends out of their depletion reserves (Tr. 487-488). The stock of Golconda has always been widely held. In 1957 there were 1,800 to 2,000 shareholders (Tr. 488). Two cents per share, totaling $40,000, was paid in dividends in 1957 (Exhs. 3C to 150, 71BS).

II. Hecla Take-Over of Lucky Friday

In 1958 Golconda owned 155,000 shares of Lucky Friday, or about 15% (Tr. 289). Toward the end of 1958, Hecla Mining Company (Hecla), one of the largest in the nation (Tr. 608), made a tender offer to the shareholders of Lucky Friday. Hecla ended up with 38% of the outstanding stock of Lucky Friday and took over control (Tr. 103-104, 491-492, 613, 778). The president of Hecla, Mr. Randall, became president of Lucky Friday, and the general manager of Hecla, Mr. Love, became a director and general manager of Lucky Friday (Tr. 492-493). From that time on, all policies of Lucky Friday, including dividends, were set by Hecla (Tr. 495).

At the beginning of 1959, Hecla announced that a 500-ton mill would be constructed on the Lucky Friday property. The Lucky Friday mill started operation in February, 1960, and at that time the Golconda mill closed down (Tr. 109, 493).

III. Decision to Attempt New Exploration

In 1959 Wray Featherstone became president of Golconda (Tr. 80). He was a mining engineer who had spent a lifetime in the Coeur d'Alene district (Tr. 76-79) and in 1956 had become a mining engineer at the Lucky Friday mine (Tr. 79). He later became construction superintendent and then assistant mine superintendent for the Lucky Friday mine and thereafter became industrial engineer for the Hecla's Star mine. After becoming president of Golconda, he worked part time for Golconda until October, 1965, when he left Hecla to work full time for Golconda (Tr. 79-80). His responsibilities at Golconda included routine corporate activities but essentially were in the location of mining claims, the conducting of assessment work, the maintenance of the property and the mill and the reporting back to the directors regarding the operations of the Lucky Friday mine (Tr. 122-123).

Following the take-over of Lucky Friday by Hecla and the announcement of Lucky Friday's new mill, the directors of Golconda had extensive discussions as to the future of the company (Tr. 168, 494, 109-110; Exh. 31AE p. 98). Because of the developments at depth in the Lucky Friday and other mines in the area, they believed that the Golconda property, particularly the east side of the Golconda property and land adjoining it on the east, had merit for an exploration program (Tr. 109-111, 494). There was similarity of possible structures in the eastern part of the Golconda area with those appearing in the Lucky Friday area (Tr. 111).

The stretch of property between the Golconda mine and the Lucky Friday mine was practically unexplored north of the Osburn fault, except for the No. 6 tunnel of the

Morning mine. This unexplored area was 3½ to 4 miles east and west along the north side of the Osburn fault and perhaps 4,000-feet wide north of the Osburn fault. It was a relatively large unexplored area with regard to other areas in the Coeur d'Alene district (Tr. 108).

By 1959, Golconda was in control of the Square Deal Mining Company, which owned the property lying to the northeast of the Golconda property, and also had a substantial stock interest in United Lead-Zinc, which was the owner of the property lying to the east of the Golconda property (Tr. 245; Exh. 20T). The directors decided that they should embark on a land-acquisition program to enlarge their control over this surrounding area with the ultimate purpose of acquiring control of a large enough area so that when metal prices improved, there would be possibility for a deep exploration (Tr. 111, 115-116, 168; 449; Exh. 20T).

Wray Featherstone, based on his work at the Lucky Friday operations, made a rough estimate in 1959 that a deep exploration to a depth of 2,000-3,000 feet on the eastern part of the Golconda area would cost $1,000,000 to $2,000,000 (Tr. 111). If sizeable ore were discovered, there would be additional costs in a mill and surface facility, including hoisting equipment, which Featherstone in 1959 estimated to cost another $1,500,000 to $2,000,000 (Tr. 112). After that time, the cost of labor and materials went up rapidly, and the cost would be substantially increased over that figure (Tr. 162, 281).

Sidney Kesten, chief geologist for American Smelting & Refining Co. (ASARCO), testified that the most significant change in mining operations in the Coeur d'Alene area had been the progression to great depth, which has

made exploration very expensive, and consolidation of a substantial area was a prerequisite to exploration (Tr. 280, 445). Kesten testified as to the cost of the deep exploration in ASARCO projects in the Coeur d'Alene area and said that there is no inherent reason why the cost of exploration of the Golconda project would be any different (Tr. 279).

Kesten testified that the exploration in their Galena mine took from 1945 to 1955 and cost between $3,000,000 and $3,500,000 before getting into production, and that did not include the construction of a mill (Tr. 264-265). ASARCO is also exploring the Coeur project, where Hecla had already spent $1,000,000 to $1,500,000 in exploration. ASARCO started in the spring of 1965 and by October 1970, when this case was tried, had spent another $6,000,000. The project is not yet completed, and the total investment, if they decided to bring the mine into production, would be on the order of $10,000,000 before ASARCO would start getting any of it back (Tr. 265-268).

ASARCO is also involved in the Consolidated Silver property, and Kesten's estimate is that the exploration cannot be conducted for less than $6,000,000. Another $2,500,000 would have to be added if sufficient ore were discovered for production (Tr. 269-271). The Caladay project, in which ASARCO is participating along with Callahan Mining and Day mines, will cost in the neighborhood of $7,000,000 for exploration, with production investment in addition if sufficient ore were discovered. Moreover, Kesten testified that always exploration costs were underestimated (Tr. 272, 276-277).

Golconda did not want to start on an exploration project if the finances were not available to carry it through. They

did not want to repeat the beginnings of Lucky Friday and other companies where the available money was used to dig a hole a few hundred feet and then the company ran out of money and desperately had to sell stock to go a few hundred feet more (Tr. 447). The day of cheap, shallow production and the small under-financed company in the Coeur d'Alene had long since passed (Tr. 443, 498, 580-589).

In the Coeur d'Alene district, companies which had little or no financial ability of their own but had properties were sometimes able to work out agreements in which they retained a 40% interest but sometimes received as little as a 25% interest. If the land-owning company has sufficient finances so that it has the possibility of doing the exploration itself, its bargaining position improves. Also, there are situations where a company is willing to come in to help finance the exploration and expect the land owner to put up part of the money. Golconda did not know what alternative would eventually work, as far as an exploration that would or would not require substantial capital on the part of Golconda (Tr. 436-440). Consequently, Golconda had to have both the property and money to receive the maximum benefit from a deep exploration (Tr. 171, 494-495).

It could be expected that 7 to 10 years would elapse between the time a deep exploration project in the Coeur d'Alene was conceived and the time when plans for the project were finally formulated (Tr. 265-267, 523-524). After exploration actually commenced, at least another ten years would probably elapse before any returns came in, even if the exploration were successful (Tr. 264-265; Exh. 69BQ p. 19).

IV. Protection of Interest In Lucky Friday

In looking forward to a deep exploration of the Golconda area, the Golconda board decided that it would not dispose of its interest in Lucky Friday to get the money for the new exploration. By an endeavor extending over eighteen years, Golconda had brought Lucky Friday to the point of being one of the largest silver, lead and zinc producers in the country. To liquidate its interest in that mine to engage in a new exploration, would not have been prudent (Tr. 115, 161, 257-258, 305, 495, 497).

In 1959-1960, when the decision was made to attempt to put together the new exploration project, Golconda had no substantial assets besides its interest in Lucky Friday (Exh. 109). The income necessary in the long period ahead to pay operating expense of the corporation, to purchase the interests in the land for exploration, to finance all or part of the exploration and to continue the dividends that Golconda had started, had to come from Golconda's interest in Lucky Friday without liquidation of that interest (Tr. 115, 171).

The Golconda board was thus greatly concerned over the continuity of dividends from its interest in Lucky Friday. The dividend policy was no longer controlled by Golconda, but by Hecla (Tr. 495-496). Immediately upon Hecla's take-over of Lucky Friday, Golconda began purchasing shares of Hecla. Three thousand shares were purchased in December, 1958, and by the end of 1960 Golconda had purchased 37,000 shares of Hecla (Exh. 109). These purchases were financed in part by bank borrowing (Exhs. 5E, 20T). The minutes of the directors' meetings of Golconda on March 10, 1959, and November 9, 1960 (quoted in Appendix D, p. A-11) show that the purchase of Hecla

stock was to protect Golconda's interest in Lucky Friday.

On July 22, 1960, Magnuson became a member of the Hecla board of directors (Tr. 779). Randall, president of Hecla, testified that Magnuson represented Golconda on the Hecla board and that he was on the board because Golconda had a major stock interest in Hecla (Tr. 780). Magnuson became a member of Hecla's executive committee in 1964 (Tr. 780-781).

In 1962 Golconda adopted the policy of selling Lucky Friday shares and purchasing Hecla shares. Lucky Friday shares had advanced very sharply in price, and it was attractive to sell Lucky Friday and buy Hecla. Each share of Hecla owned indirectly 44/100 of a share of Lucky Friday. A point was reached where Golconda could sell a Lucky Friday share, pay its capital gain tax, buy two shares of Hecla and own 88/100 of a share of Lucky Friday and be back about where it was before, except that it was a further factor in the controlling company (Tr. 172, 501, 612).

Effective on April 1, 1964, Lucky Friday was merged into Hecla at a ratio of 1½ shares of Hecla to one share of Lucky Friday (Exh. 72BT; Tr. 500). Part of the original Lucky Friday shares had already been converted into Hecla shares, prior to the merger, by sale of Lucky Friday and purchase of Hecla as above mentioned. Consequently, at the time of the merger, Golconda already owned 99,600 shares of Hecla. Golconda received an additional 205,650 shares of Hecla in the merger in exchange for the Lucky Friday shares still held, making a total of 305,250 shares of Hecla held by Golconda after the merger. The total cost

base of all of these shares was $1,433,895.22* (Exh. 110).

These shares were held by Golconda without change after the merger until February, 1966, when a program of acquisition of Hecla stock was commenced during the merger negotiations. At the end of 1966, Golconda held 323,600 shares of Hecla (Exh. 110).

V. Implementation of Decision as to Exploration

Following the decision of the Golconda directors in 1959 to put together a new mining exploration, immediate and continuing steps were taken to develop the project and to keep the Golconda stockholders advised concerning it. In the Coeur d'Alene area, the land is generally held by many smaller corporations. The stock of these corporations was fairly widely held, some companies having up to 900 stockholders (Tr. 89-91, 246). It was usually not possible to purchase the land from these corporations because, in most cases, the mining claims were the only assets, and the stockholders of those companies would not sell the land. As a practical matter, an interest in the land could be secured only by the purchase of shares of stock in the corporations (Tr. 144-146, 169).

There are two types of ownership in a mining area—one is a patented mining claim which vests full title, and the other is an unpatented mining claim which gives certain rights of exploration. To retain title to an unpatented mining claim, it was required by United States mining law that $100 worth of work be done for the benefit of each claim each year (Tr. 117-118). At the time the decisions

*The "year 1965 capitalized costs" shown on Exh. 110 in connection with the cost base of this stock consisted of acquisition costs originally capitalized as a cost of the stock but which the Internal Revenue Service in the present audit required to be expensed currently in the year involved. Golconda has not contested that requirement.

were made by the directors following the Hecla take-over of Lucky Friday, Golconda had several unpatented claims of its own and also was doing assessment work on a number of unpatented claims owned by surrounding companies which had no liquid assets. This included five unpatented mining claims of Square Deal, 22 unpatented claims of United Lead-Zinc, 12 unpatented claims of Mullan Silver-Lead and 10 unpatented claims of Granada (Tr. 117-119). In the years after 1960, the assessment work and location of new mining claims was accomplished by Wray Featherstone, who did part of the work personally, and the balance of the work was done under his direction. He hired people to work in the field and hired work by mechanical equipment. In general, the work consisted of maintenance of portals, deepening of existing openings, making discovery cuts, construction and maintenance of roads and bulldozer cuts for geological study purposes (Tr. 123-124, 298-301). In doing this assessment work, Golconda in some instances was protecting a stock interest held by Golconda in the company owning the claims and also was trying to maintain the standing of the claims in the area which eventually might receive an exploration project (Tr. 119).

During the years 1958 through 1969, Golconda aggressively purchased stock in the companies owning the land adjacent to the Golconda property and purchased property and located mining claims in that area. Exhibit 107 outlines the purchases of the stock of companies owning land in the area, and Exhibit 119 outlines the purchase of property or location of mining claims in the area. The year-by-year extension of Golconda's control of the area was marked on the map (Exh. 115) by Featherstone, president of Golconda, as he testified to the continuing acquisitions

between 1958 and 1969 (R. 133-160).

Among the transactions by which Golconda acquired control of the area for exploration, were definitive contracts, whereby Golconda received stock in return for assessment work and other services performed or to be performed by Golconda (Exhs. 99CU, 100CV, 102CX, 101CW).

The annual report to stockholders for 1959 stated that Golconda owned a controlling stock interest in Square Deal, which owned the property lying to the northeast of the Golconda property, and a substantial stock interest in United Lead-Zinc, which owned the property lying to the east of the Golconda property. The report further stated that preliminary steps had been taken which might lead to further exploration of Golconda's property holdings, that several areas geologically attractive for ore deposition are indicated, and that an extensive exploration program might be warranted whenever higher metal prices prevail (Exh. 20T). Thereafter, the annual reports to stockholders from 1960 through all the years involved in this case, also advised the stockholders that efforts would be made to secure a deep exploration of the Golconda area and included maps showing the progress in acquiring the land (Exhs. 21U, 22V, 23W, 24X, 25Y, 26Z, 27AA).

Featherstone reported to the shareholders on March 12, 1963, that when Golconda's ownership of the area had been increased, it would explore the area at depth (Exh. 31AE p. 146). On November 5, 1963, he estimated the cost of exploration at $3,000,000 to $5,000,000 or more (Exh. 31AE pp. 154-156).

Metal prices, particularly lead, had been in a long de-

cline from 1950 and reached a very low level in 1962. In 1963 there was a turn-around (Exh. 121; Tr. 152, 522). In view of this turn-around, the Golconda directors at the end of 1963 authorized a geological study by Shenon & Full, independent geologists with extensive experience in the area (Tr. 153-154). The Shenon & Full report was received by Golconda at the end of October, 1964. It recommended deep exploration in two parts of the Golconda area (Exh. 39AM).

At the directors' meeting November 9, 1964, the Shenon & Full report was discussed. While the directors desired to unitize the eastern area of the Golconda property, as Shenon & Full recommended, and conduct a deep exploration, they felt that Golconda did not at that time have the available assets to do it without liquidating Golconda's interest in Hecla, which owned the Lucky Friday mine. The directors did not desire to liquidate that asset for the purpose of a risky exploration program which, if it did not develop into a successful mine, would have left Golconda without its basic asset (Exh. 31AE p. 182; Tr. 160).

Golconda's registration statement filed with the SEC November 17, 1965, quoted *infra* pp. 55-56, stated that Golconda intended to undertake the exploration either by itself or in conjunction with other companies (Exh. 55BC pp. 2889-29 and 30).

VI. Purchase of Bunker Hill Stock

The Bunker Hill Company had several mines in the Coeur d'Alene and owned the largest interest (70%) of the Star-Morning mine which was adjacent to the proposed Golconda exploration area. One possibility of exploration of the Golconda area was through the Star mine (Tr. 447, 519, 542-543; Exh. 31AE pp. 162, 167, 171). The minutes

of the Golconda directors' meeting of February 4, 1964, indicate that the primary reason why Golconda was interested in purchasing Bunker Hill stock was because of the future advantages such ownership might bring in the development of the Golconda area through the Star workings (Exh. 31AE p. 162). An excellent opportunity to become a Bunker Hill stockholder was presented in late 1962 and 1963, when the price of Bunker Hill stock reached a very low level (Tr. 543). Golconda acquired 61,405 shares of Bunker Hill between 1961 and 1964 (Exh. 109).

During 1964 Bunker Hill and Hecla, the operator of the Star mine, agreed on an expansion program in that mine (Tr. 217-218). By 1965 Featherstone, president of Golconda, who was at that time working for Hecla in the Star mine, could see that this program precluded use of the Star facilities for any exploration in the Golconda area (Tr. 217-218, 316). Golconda sold most of its Bunker Hill stock in 1965 and 1966 (Exh. 109).

VII. Investment Company Act

Because more than 40% of its noncash assets were in securities, Golconda was required by the SEC in 1965 to register as an investment company under the Investment Company Act of 1940 (Tr. 550-551; Exhs. 43AQ, 55BC) cf USC Tit. 15 §80a-3(a)(3).

VIII. Exploration and Merger Discussions with Hecla

Golconda had continuing discussions with Hecla concerning exploration of the area, commencing in 1961 (Tr. 315). Hecla was a particularly suitable company for doing the exploration of the Golconda area because Hecla was the operator not only of the Lucky Friday mine but also of the nearby Star Morning property (Tr. 518, 181-182).

Also, Golconda was concerned about its interest in Lucky Friday. If an arrangement could be made with Hecla, then Golconda could have brought both of these objectives into common focus (Tr. 637-638).

While the general pattern in the Coeur d'Alene was an operating agreement in bringing about an exploration program, Golconda also explored during these years the possibility of accomplishing its objectives by merger. In an exploration agreement where there is a landowner on the one hand and an operator on the other hand, there are possibilities of conflict in allocation of costs, programs of exploration to be carried out, timing, etc. Where there is a merger, the possibility of such conflict is reduced (Tr. 516-517).

Consequently, along with the discussions concerning an exploration agreement which commenced in 1961, discussions between Golconda and Hecla as to a merger of the two companies also commenced in April, 1962 (Exh. 79CA; Tr. 520, 787-789), and went on fairly continuously during the years here involved (Tr. 182, 213, 525, 532, 537; Exh. 133).

IX. Ownership of Golconda Stock

Golconda had one class of stock and 2,000,000 shares outstanding in the years through 1965 and 1,933,000 shares outstanding at the end of 1966 (Exhs. 21U to 27AA). During the period involved in this case, the Golconda stock was listed on the Spokane Stock Exchange, the Salt Lake City Stock Exchange, the National Stock Exchange in New York City and the Vancouver, B.C., Stock Exchange (Tr. 573-574). In 1966 Golconda had 2,631 shareholders of record (Exh. 106). A list of the stock-

holders and the number of shares owned by each as of the dividend-payment date, November 12, 1965, is in evidence (Exh. 98CT).

The shares owned by directors at the end of 1966 were as follows: Magnuson had 157,975 shares. If the shares held by the custodianship for his children were added, the total would be 195,525 shares, which was 10.1% of the total shares outstanding (Exh. 104). Wray Featherstone had 28,700 shares; Carl Turner, 73,905 shares; Walter Sly, 15,000 shares; C. E. Bloom, 2,000 shares (Exh. 103). Thus, the total shares owned or controlled by the directors at the end of 1966 was 315,130 shares, which was slightly over 16% of the stock outstanding.

The largest stockholder of Golconda until it disposed of its shares during 1966, was David A. Noyes & Co., a Chicago stock brokerage company. At the beginning of 1966, it owned of record 204,875 shares (Exh. 105). The man in that brokerage firm responsible for and handling this stock was William L. Graham, Jr. (Tr. 544-545). Mr. Graham claimed to control the voting of far more stock than was registered in the name of his brokerage company. He advised Magnuson on many occasions that he had approximately 440,000 shares under his control (Tr. 545-546). This was approximately 22% of Golconda's outstanding stock and was substantially more than all of the stock owned by the directors of the company.

In a letter dated March 16, 1966 (Exh. 134), Chicago attorneys for Graham wrote to Hecla, stating that Noyes was spokesman for 425,000 shares of Golconda and stating that the interest of this Chicago group in Hecla, through its ownership of Golconda stock, was the largest group interest in Hecla and as such was entitled to representation

on the Hecla board. Thereafter, Graham commenced to liquidate his stock and became very abusive. He was making threats against Hecla and against the chairman of the board of American Smelting (Tr. 667, 759). This situation came about at a time when Golconda and Hecla were close to agreeing on a merger. Graham was muddying up the works (Tr. 667). It was important in the merger negotiations for Golconda to maintain a reasonable price for its stock to keep its bargaining position (Exhs. 87CI, 92CN, 93CO, 131, 132; Tr. 347-348, 667). Because of this situation with Graham (Tr. 667), at the directors' meeting March 29, 1966, the officers were authorized to acquire up to 70,000 shares of Golconda within a price range of $6 to $7 per share (Exh. 31AE p. 223).

The number of new shares that Hecla would have to issue was a factor in the merger negotiations. By purchasing its own shares, Golconda could minimize the number of new shares Hecla might have to issue in the merger (Tr. 759). On May 11, 1966, Hess gave Magnuson a memo analyzing whether it was better for Golconda to buy Hecla or Golconda shares at current market prices in order to reduce the numbers of new Hecla shares that would be required in a merger. This showed that there was a distinct advantage in buying Golconda shares and supported the decision that had been made to purchase Golconda shares (Exh. 132).

Golconda purchased 67,000 shares of its own stock in 1966 at a total price of $485,600 (Exh. 27AA).

X. Events After 1966

Negotiations for a merger between Hecla and Golconda reached a high point in the middle of 1966 (Exhs. 92CN,

93CO, 94CP) and continued as late as February, 1967 (Tr. 537; Exh. 133). No agreement could be reached on the exchange ratio, and the negotiations terminated. On May 19, 1967, Hecla wrote Golconda, stating that Hecla was interested in an exploration program in part of the Golconda area, which would include the properties of Mullan Silver-Lead, Alice Silver-Lead, United Lead-Zinc and two claims owned by Golconda (Exh. 95CQ).

In October, 1968, Hecla began to negotiate with El Paso Natural Gas Company for the issuance of 1,000,000 shares of Hecla stock for a one-half interest in the Lakeshore property of El Paso (Tr. 801-802). This transaction was to be accompanied by an operating agreement on the Lakeshore property with Hecla supplying the funds for the development (Tr. 802; Exh. 30AD). Golconda actively opposed this transaction and brought suit to prevent it for the reason that the proposed transaction would very materially reduce the net earnings and dividend-paying capacity of Hecla for a substantial number of years and would also reduce the market value of its shares (Tr. 313, 554, 802; Exh. 31AE p. 292). The court decided in favor of Hecla (Tr. 313).

Hecla ceased paying dividends in 1970 (Tr. 554; Exh. 31AE, 2d Series, p. 84).

XI. Exploration Agreement

On June 13, 1969, Hecla and Golconda signed a preliminary agreement for the unitization and deep exploration of the eastern portion of the Golconda area (Exh. 31AE, 2nd Series, p. 20, 96CR). Under this agreement a new corporation was formed called Alice Consolidated Mines, Inc., to receive the properties which were to be unitized for

this exploration (Tr. 220; Exh. 96CR). The properties were conveyed to this corporation by the various owners in exchange for stock based on determination by outside consultants as to the relative contribution each property would make to the development (Tr. 219-220; Exh. 96CR). Golconda received approximately 54% of the stock of Alice Consolidated (Exh. 30AD p. 4, Exh. 31AE, 2nd Series, p. 85).

On April 3, 1970, pursuant to the preliminary agreement between Hecla and Golconda, a project agreement was entered into between Alice Consolidated and Hecla (Exh. 69BQ). Under this agreement, Hecla agreed to install a hoist and surface facilities capable of handling 400 tons of ore from a depth of 2,000 feet. Having done so, Hecla may, at any time thereafter, terminate the agreement. The agreement provides that Hecla intends to carry on a further work program, consisting of the sinking of a shaft to an estimated depth of 2,000 feet, driving 4,500 feet of laterals and 15,000 feet of diamond drilling. This work was to be completed within five years. After that, further work was to be at Hecla's discretion, but if a producing mine operation were not achieved within ten years, the minimum royalty was increased from $300 a month to $1,000 a month (Exh. 69BQ). The agreement gave Alice Consolidated, as the land-owner, 50% of the net profits from the property (Exh. 69BQ). Also the preliminary agreement gave Golconda the right, in addition to its interest in Alice Consolidated, to elect to acquire up to a 25% interest in the operating agreement (Exh. 96CR).

Golconda elected to take 20% of the operating interest (Tr. 220-222; Exh. 30AD p. 4). If the costs were $6,000,000 to $10,000,000 as testified to by Kesten, Golconda could be liable for 20% thereof (Tr. 441; Exh. 112).

XII. Dividend Policy of Golconda

After commencing dividends in 1957, Golconda has continued to pay dividends continuously on a semi-annual basis (Tr. 555). The annual dividends were 2c per share in the years 1957 through 1961, 4c per share in 1962 and 1963, 5c per share in 1964, 7c per share in 1965, 9c per share in 1966, 11c per share in 1967 and 12c per share in 1968 and 1969 (Exh. 71BS).

When the directors started paying dividends in 1957 they desired to establish a policy that would have continuity. The directors felt that in a public company it is misleading to start dividends and not carry them on, or to pay out everything in one year and drop dividends in the next (Tr. 178-179, 489-490, 558).

Despite the cessation of Hecla dividends in 1970, Golconda continued thereafter to pay dividends to its stockholders at its then going rate (Exh. 31AE, 2d Series, p. 87).

Mining companies should have dividend policies different from non-mining companies because their principal asset is an ore body, which is a wasting asset (Tr. 590). If the corporation wishes to maintain its corporate being, it has to acquire other ore bodies. The distinction between the companies which survive and those which fail is the foresight of the directors in maintaining reserves to take advantage of future opportunities or for acquiring other properties or interests in them (Tr. 584-590).

XIII. Golconda's Financial Position

Schedule C of Appendix B, *infra*, p. A-8, is a summary of Golconda's balance sheets and income statements for the years 1960 through 1966, taken from Exhibits 21U through

27AA. Schedule D of Appendix B, *infra*, p. A-9, is a comparison for the same years of net income, capital gains after tax thereon, net income less capital gains, dividends paid and retained earnings.

On December 31, 1966, at the then quoted market price of $43 per share, the 323,600 shares of Hecla owned by Golconda had a quoted value of $13,914,800 (Exh. 27AA, 109)

At the end of 1966, Golconda owned more than 10% of the outstanding stock of Hecla (Exh. 27AA).

Of the other stock owned by Golconda at the end of 1966, the Bunker Hill Company stock had a quoted market value of $131,250; the stocks of the land-holding companies in the projected exploration area had an approximate value of $959,391; stocks of other companies owning land in the same eastern area of the Coeur d'Alene mining district had an approximate value of $128,061; stocks of companies owning land in other areas of the Coeur d'Alene district had an approximate value of $259,760; and stocks of other mining companies had an approximate value of $190,738 (Exh. 109).

Donald Hess, CPA and secretary-treasurer of Golconda, testified that in his opinion Golconda did not have sufficient liquid assets to meet the reasonable needs of its business and to declare additional dividends in any of the years involved, including 1966 (Tr. 722-737). He had prepared Exhibit 140 showing his computations supporting this result. In this computation he treated all Hecla stock and all stocks of companies held because of their property in the proposed exploration area as assets which Golconda should not be required to liquidate to meet future exploration costs or to pay dividends. He testified that Golconda regarded the Bunker Hill stock as likewise not a liquid asset because purchased to further the exploration plans, but in order to be conservative, he included it as a liquid asset (Tr. 725). Because his exhibit related to years as early as 1962, his estimate of future cost of exploration and production facilities was taken from Featherstone's estimate made in 1959 of exploration cost of $2,000,000 and production facilities of $1,500,000 (Tr. 11, 727, 731). He deducted applicable capital gains tax which would be incurred in liquidating the stocks he listed as available for dividends. When the available liquid assets were applied to the debts, reserves and future needs as so computed, a substantial deficit was present in every year (Exh. 140).

XIV. Effect on Directors of Distribution of Earnings and Profits Retained Per IRS Letter

Hess also prepared Exhibits 135 to 139, showing the taxes which would have been payable by each of the directors if an additional dividend had been declared each year of all current earnings and profits retained, as shown by the Internal Revenue Service's 90-day letters (R. 9-19; Tr. 697). Distributions in these amounts would have eliminated any possibility of an accumulated earnings tax, even though capital gains are not included in the amounts (Tr. 697-698). The additional taxes on all of the five directors together if such a distribution had been made in 1966, would have been $7,676.77.

Revenue Agent Dodson prepared Exhibit DR, showing that tax effect on the directors of Golconda if all of the earnings and profits of Golconda, including capital gains, had been distributed. The additional tax on all of the five directors together would have been $41,294.89. Dodson admitted that capital gains are excluded from the accumulated earnings tax (Tr. 767).

XV. Decision of the Tax Court

The Tax Court (58 TC No. 13; R. 70), after summarizing the facts hereinbefore set forth, held that Golconda was not a mere holding or investment company within the meaning of IRC §533(b) but that the accumulated earnings tax could be applied to Golconda even though it was a publicly-held company and the directors and officers as a group held less than 17% of the stock. The Court further held that Golconda had specific, definite and feasible plans for the new mining exploration, for which it was entitled to accumulate funds, but that it was not entitled to accumulate enough funds to accomplish the entire exploration itself because it was trying to secure an agreement whereby another company would put up part of the funds.

The Court then held that Golconda was not subject to the accumulated earnings tax in the years 1962 through 1965 but was subject to the tax in 1966 on the ground that in that year Golconda had accumulated a portion of its earnings and profits beyond the reasonable needs of its business. In reaching this conclusion, the Court held that Golconda, to pay dividends and future business needs, was not obligated to liquidate the stock of companies purchased to get control of land in the exploration area, nor was it obligated to liquidate Hecla stock which arose out of Golconda's original interest in Lucky Friday, but was obligated to liquidate all other Hecla stock purchased from 1958 on. The Court computed the value of stocks at the quoted market figures at the end of the year and held that Golconda had $3,755,548 in investment assets at the end of 1966. The Court held that in 1966, Golconda had reasonable business need for $3,150,000 in investment assets. In this figure, the Court included only $2,500,000 for the exploration.

By motion for reconsideration, Golconda pointed out that its accumulated earnings and profits at the end of 1966 were less than the reasonable business needs found by the Court, that the Court had used unrealized increase in market value of assets, rather than earnings and profits, to compare with reasonable business needs, and urged that this was improper under the statute. Golconda also urged that the stocks which the Court had held to be liquid assets available at the end of 1966, could not have been then liquidated for enough to cover the reasonable business needs found by the Court, because Golconda was a controlling person of Hecla under the Securities Act, and its Hecla stock could have been liquidated only by secondary offering or private placement, both involving large discounts, and also because the Court had ignored capital gain taxes and brokerage commissions.

In a supplemental opinion (58 TC No. 73; R. 188), the Court held that the Commissioner could impose the accumulated earnings tax based on unrealized market value of assets by examining whether future retention of earnings is an unnecessary addition to existing corporate liquidity; that the Court could not compute the capital gains tax that might be paid; and that the discount and expense of a secondary offering need not be considered because Golconda would only need the money over a period of years and could liquidate the stock gradually.

ARGUMENT

I. Application of Accumulated Earnings Tax to Publicly-Held Company Is Contrary to the Administrative and Legislative Construction of the Law

In the half century of existence of the accumulated earnings tax, this is the first case, as far as we can find, where the tax was imposed on a publicly-held corporation such as Golconda. While *Trico Products Corp. v. Commissioner*, 137 F.2d 424 (CA2 1943) is often cited in this connection, a small group of stockholders, which had past cohesive relationships, held 70% of Trico's shares.

During this half century, the settled administrative construction of the Act, communicated to the public and acted upon by Congress, has been to the effect that the tax was not applicable unless more than 50% of the stock was owned by a family or a small cohesive group. No change in this construction has ever been announced by the Commissioner, and it should be determinative here. No family or small cohesive group owned 50% of Golconda's stock.

The accumulated earnings tax began in the Revenue Act of 1913 (38 Stat. 166), which provided that if a corporation was formed or availed of for the purpose of escaping the individual income tax by permitting gains and profits to accumulate, each shareholder's ratable share of the corporate income was taxable to him, whether distributed or not. May we point out that the difficulty of applying this to corporations with thousands of small stockholders is itself an indication that the Congress was thinking of closely-held corporations in enacting this statute.

Sec. 220 of the Revenue Act of 1921 (42 Stat. 227) changed the format to one of a tax on the corporation

unless all of the stockholders agreed to pay tax on their distributive shares. The difficulty of securing agreement by thousands of small stockholders again emphasizes that the statute was aimed at closely-held corporations.

Sec. 220 of the Revenue Act of 1924 (43 Stat. 253) for the first time dropped the possibility of taxing the shareholders on the undistributed income. In connection with that Act, the Treasury issued regulations stating (Regs. 65, Art. 352):

> "The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 220 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its stockholders."

This language was repeated in the regulations under the 1926 Act (Regs. 69, Art. 352), under the 1928 Act (Regs. 74, Art. 542) and under the 1932 Act (Regs. 77, Art. 542).

While this language of the regulations was dropped after the 1932 Act, there was no language inserted indicating any change of position by the Commissioner. The construction of the Act adopted by these regulations, to the effect that the tax was not applicable unless the stock was held by a family or small group, continued thereafter. This is shown by the fact that no attempt has been made to impose the tax on a publicly-held company where a majority of the stock was not closely held, and by the events connected with the passage of the Internal Revenue Code of 1954. When the Act adopting that Code passed the House

as HB 8300, 83d Congress, 2d Session, the bill contained (§532) a provision that the accumulated earnings tax should not apply to a publicly-held corporation, which was defined as a corporation the outstanding stock of which is owned by more than 1,500 persons and not more than 10% by any individual. HR 1337, 83d Congress, 2d Session, p. 54, stated with regard to this section:

> "(4) *Publicly held companies.*—Under present law the section 102 tax is theoretically applicable to publicly held as well as closely held companies. As a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group. Some publicly held corporations have nevertheless been apprehensive of the possible application of the provision.
>
> "Inasmuch as the area of tax avoidance through retention of corporate earnings is confined to closely held companies, your committee has provided a specific statutory exception for any corporation which has more than 1,500 shareholders and no more than 10% of the stock of which is held by any individual (including the members of his family). The corporation must demonstrate its right to the exception by showing that it meets the stock ownership requirement."

Sec. 532 of the bill was deleted in the Senate. The explanation given by Senate Report 1622, 83d Congress, 2d Session, p. 69, was as follows:

> "Under present law the section 102 tax is theoretically applicable to publicly held as well as closely held companies. As a practical matter, the provision has been applied only in cases where 50 percent or more of the stock of a corporation is held by a limited group.
>
> "The House bill provided a specific statutory exception for any corporation which has more than 1,500 shareholders and no more than 10 percent of the stock of which is held by any individual (including the

> members of his family). The corporation must demonstrate its right to the exception by showing that it meets the stock ownership requirement.
>
> "Testimony before your committee has indicated that it would be very difficult for many corporations which are generally recognized to be publicly held to establish from its records that not more than 10 percent of its stock is held by an individual and members of his family. Yet if publicly held corporations are to be exempted from this tax it is recognized that a requirement of this type is needed. In view of this and the fact that this tax is not now in practice applied to publicly held corporations, your committee believed it was desirable to remove the exemption provided for such corporations by the House bill."

That this statement of Congress indicated the settled construction of the accumulated earnings tax, was recognized by the Supreme Court in *US v Donruss Co.*, 393 US 297 (1969), where Justices Harlan, Douglas and Stewart stated in their separate opinion (p. 310):

> "In practice the accumulated earnings provisions are applied only to closely-held corporations controlled by relatively few shareholders."

The court cited the Senate Report above mentioned as support for this statement.

We submit that where an administrative construction of a statute is as long-continued as that here and where Congress has been persuaded not to enact an exemption on the basis that this settled construction makes the exemption unnecessary, the construction so adopted is not to be disregarded. Certainly it should apply at least until the Treasury adopts a new interpretation by regulation or ruling of general application.

The long-continued interpretation of a statute by the

agency charged with its administration, where Congress has re-enacted the Code without change, is deemed to have Congressional approval and has the effect of law. *Helvering v. Winmill*, 305 US 79, 83 (1938); *Corn Products Ref. Co. v. Comr.*, 350 US 46, 52-53 (1955); *FHA v. The Darlington*, 358 US 84, 90 (1958); *US v. Dakota-Montana Oil Co.*, 288 US 459 (1933).

Administrative practice which is to be considered in the construction of a statute may arise even from the non-assertion of power. The Supreme Court stated in *Federal Trade Comm. v. Bunte Bros.*, 312 US 349, 351-352:

> "That for a quarter century the Commission has made no such claim is a powerful indication that effective enforcement of the Trade Commission Act is not dependent on control over intrastate transactions. Authority actually granted by Congress of course cannot evaporate through lack of administrative exercise. But just as established practice may shed light on the extent of power conveyed by general statutory language, so the want of assertion of power by those who presumably would be alert to exercise it, is equally significant in determining whether such power was actually conferred."

To the same effect, see *US v. Cooper Corp.*, 312 US 600, 613-614; *US v. Farrar*, 281 US 624; *Federal Power Commission v. Panhandle E.P.L. Co.*, 337 US 498, 513; *Overnight Motor Transp. Co. v. Missel*, 316 US 572, 580 (footnote).

A half century in which the accumulated earnings tax has never been asserted against a company unless a family or small group with cohesive relationships owns more than 50% of the stock, would thus qualify as an administrative interpretation of the Act even in the absence of the regulations and Congressional committee report referred to above.

It is the general rule that an agency's interpretation of a statute may be changed, even retroactively and even though the basic statute has been re-enacted by Congress (where Congress has not commented on the construction which has been given to it), as long as the new interpretation is a permissible one. *Dixon v. US*, 381 US 68; *Helvering v. Wilshire Oil Co.*, 308 US 90; *American Chicle Co. v. US*, 316 US 450. However, where Congress has directly indicated its legislative intent, any interpretation adopted, whether originally or by change, which is contrary to that intent, is invalid. *Helvering v. Sabine Transportation Co.*, 318 US 306. Cf. *Helvering v. Reynolds*, 313 US 428, upholding retroactive change in regulations but distinguishing situations where there have been explicit statements of Congressional purpose.

In *US Truck Sales Co. v. US*, 229 F.2d 693 (CA6 1956), the administrative practice not to impose a manufacturer's excise tax on sales of secondhand cars had been referred to and relied upon in a House committee report on legislation involving the tax. The court held that the Commissioner could not validly change this practice.

The same situation exists here. Congress has directly indicated its agreement with the long-continued administrative construction by dropping consideration of an amendment which would have been definitive on application of the tax to publicly-held corporations. We submit that if a change is to be made from the construction of the Act so recognized by Congress, that change must be made by Congress. *US v. Empey*, 406 F.2d 157 (CA10 1969).

Even if this were a situation where the Commissioner validly could change the existing administrative construc-

tion of the Act, he has not here done so. We have no new regulation or public announcement stating that the Commissioner no longer will follow the established practice of not applying the accumulated earnings tax unless a family or small group with cohesive relationships owns more than 50% of the stock. We have simply the act of a revenue agent and his review personnel seeking to apply to one taxpayer a view of the meaning of the law contrary to the settled administrative interpretation. We submit that this is not an exercise by the Commissioner of Internal Revenue of any power he might have to change the administrative construction.

Since there is no public announcement here of change of position, the factual situation is not even as favorable to the Commissioner as that in *Crespo v. US*, 399 F.2d 191 (Ct. Cl. 1968), where the Commissioner did announce a change of interpretation but did not state that it would be applied retroactively. The court refused to apply it retroactively and held that the prior interpretation governed the case.

The necessity for determination and public pronouncement, through regulations or otherwise, by the Commissioner of a change in administrative construction in a case such as this, becomes even more apparent when the question of abuse of discretion on retroactivity is considered. The Commissioner has general authority to correct a mistaken construction of the law by retroactive ruling or regulation. *Automobile Club of Michigan v. Comr.*, 353 US 180; *Dixon v. US*, 381 US 68. However, such a change may be reviewed to see whether the Commissioner has abused his discretion in making the change retroactive. *Automobile*

Club of Mich. v. Comr., supra. If the change is not applied equally to all taxpayers similarly situated, the change would be discriminatory and invalid. *US v. Kaiser*, 363 US 299.

The Court of Claims has applied this doctrine in a series of cases, where it has held that a change in administrative interpretation cannot be applied retroactively against a taxpayer unless the situation is such that it will be likewise applied against other taxpayers having similar factual situations. *International Business Machines Corp. v. US*, 343 F.2d 914 (Ct. Cl. 1965); *Exchange Parts Co. of Fort Worth v. US*, 279 F.2d 251 (Ct. Cl. 1960); *Connecticut Ry. & Lighting Co. v. US*, 142 F. Supp. 907 (Ct. Cl. 1956).

The same principle was applied by the United States District Court, Northern District of Ohio, in *City Loan & Savings Co. v. US*, 177 F. Supp. 843 (1959), where long-standing IRS practice had been made public by an acquiescence by the Commissioner in a Tax Court decision. In an audit of City Loan, the Appellate Division of the Internal Revenue Service decided to take a position different from that which had been announced by the Commissioner and assessed tax accordingly. City Loan paid the tax and filed claims for refund. A year later, the Commissioner withdrew his acquiescence in the Tax Court decision. Nevertheless, the District Court granted City Loan the refund, one of its grounds being that the Commissioner abused his discretion in making an individual, retroactive and discriminatory application of a change of position. The Sixth Circuit affirmed the District Court decision in the *City Loan* case (*US v. City Loan & Savings Co.*, 287 F.2d 612), stating that the administrative practice of the Com-

missioner for so many years was not to be disregarded lightly.

In the *City Loan* case, the Commissioner did announce a change of position, albeit belatedly. Here we have no change of position announced by the Commissioner. Without a new interpretation generally announced, there is no reason to believe that all revenue agents auditing returns have applied the same view of the law as has been applied to Golconda. In fact, it is to be presumed that auditing agents have generally applied the settled practice that was communicated to, announced by and relied upon by Congress. Under these circumstances, to decline to follow the established practice in the audit of one taxpayer is, we submit, discriminatory under the rule of the above cases.

A further consideration supports the continuation of the settled construction of the Act at least until the Commissioner announces a change in that construction. Were the Commissioner to change this construction, it is a reasonable assumption that Congress again might wish to consider this type of legislation. Consequently, such a change should be made by public ruling or announcement of general application by the Commissioner, which would bring the matter to the attention of Congress and give that body a chance to act.

The Tax Court opinion below dismissed our argument on this point by stating that the Senate Committee recognized that the accumulated earnings tax was theoretically applicable to publicly-held companies (R. 109). This ignores, however, the limitation on the theoretical application of the Act resulting from the settled practice of the Internal Revenue Service and the evident reliance of Con-

gress on the continuation of that limited construction of the Act.

Throughout the Internal Revenue Code is language that, taken in a theoretical sense, could have an application to situations different from those Congress was attempting to reach. It is primarily for this reason that rule-making power is given to the Commissioner. Every interpretation, practice, regulation and ruling lends definitiveness to the statutory language, and many of them circumscribe what might otherwise be theoretical applications of that language. Taxpayers and the courts rely on such interpretation in applying the statutory language. Even if the basic statutory language is susceptible of a broader interpretation, where a more restricted interpretation is confirmed by direct indication of Congressional intent, the interpretation cannot be broadened without Congressional action as above discussed. Moreover, where there is no such direct indication of Congressional intent, so that the Commissioner may broaden the interpretation within the basic statutory language, he still may not make the new interpretation retroactive in a discriminatory manner, as above discussed.

Thus, the fact that the language of the accumulated earnings tax theoretically could encompass public corporations is no answer to the fact that the Commissioner, in practice, has not interpreted the purpose of the language as reaching such corporations, and that Congress has refrained from making the language more certain, relying on the continuation of such interpretation.

The Golconda stock was widely held in small blocks

(Exh. 98CT). There were no family relationships between the directors or major stockholders, other than the relationship of cousin between Wray Featherstone and John Featherstone (Tr. 485).

Basic reasons exist for a distinction between publicly-held and closely-held corporations in applying the accumulated earnings tax. Public responsibility requires that the directors of the publicly-held corporation exercise greater care in acting for the best interests of all of the shareholders. The large number of shareholders who would be adversely affected by prospective financial difficulties of the taxpayer, justifies a more conservative dividend policy. The general public investing in stocks expects and relies upon continuous flow of dividends at more or less the same rate, rather than a large dividend one year and little or nothing the next.

Public pressure for the payment of dividends and the effect of dividend payments on the market price of the corporation's stock in a publicly-held corporation, assure distribution of dividends to the maximum extent consistent with the continuity of dividends and future business requirements. Moreover, one of the basic precepts in application of the tax is that even if, under threat of the tax, a closely-held corporation distributes, in dividends, funds it later finds it needs, the stockholder can contribute the funds back to the capital of the corporation. Where there are thousands of small stockholders, however, this is not feasible, and once the money is distributed it is gone so far as meeting any future emergency of the corporation is concerned.

Another consideration distinguishing a publicly-held from a closely-held corporation is the impact of the accumulated earnings tax from an equitable standpoint. Where the stock of the corporation is widely held, the burden of the penalty tax is borne by the general public which did not itself make the decisions as to dividends.

All of these factors could well be the reasons why Congress was concerned with the application of the penalty to publicly-held corporations and why the administrative practice for half of a century has been not to apply the tax to them.

II. Tax Court Improperly Used Market Value of Assets Instead of Earnings and Profits to Compare with Reasonable Business Needs

The imposition of the accumulated earnings tax for the year 1966 was specifically based by the Tax Court on its holding that petitioner had accumulated earnings and profits beyond the reasonable needs of the business under IRC §533. However, the accumulated earnings and profits at the end of 1966 were less than the reasonable needs of the business as found by the Tax Court. Nevertheless the Tax Court held that sec. 533 applied because the unrealized fair market value of assets, held by the court to be non-business related, exceeded the reasonable business needs. We submit that there is no authorization in the statute for this holding.

IRC §533 provides:

> "(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to

avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

The statute directly requires comparison of two figures, one being earnings and profits and the other being reasonable needs of the business, and the first must exceed the second before the statute can apply. The Regulations recognize that there must be a comparison of these two figures. Reg. §1.537-1(a) states:

> "An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent business man would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." (emphasis supplied)

Moreover, these two figures are to be determined without reference to unrealized increase in market value of assets or to corporate liquidity. Prior to the 1936 Revenue Act, the statute used the phrase "gains and profits" (c.f. §220 Revenue Act 1921). Sec. 102 of the 1936 Revenue Act changed the language "gains and profits" to "earnings and profits." With regard to this, the report of the Senate Finance Committee (74th Congress, 2d Session, Sen. Rep. 2156) stated (p. 17):

> "The bill as reported substitutes for the word 'gains' the word 'earnings' wherever 'gains' is used in the section in connection with the word 'profits'. The phrase describes the fund out of which taxable dividends are paid. The substitution makes no change in existing law but more accurately describes such fund and uses the same expression as is employed in §115 and elsewhere in the Act."

Taxable dividends are not paid out of unrealized in-

crease in market value of corporate assets. If, for example, a corporation without any current income or earned surplus were to declare dividends, they would not be taxable income, no matter what the unearned increase in market value of the corporate assets happened to have been.

The phrase "earnings and profits" is used in many aspects of the Federal income tax law. It is a term of art with a specific meaning in the income tax field, allowing for a precise factual determination. Increase in value of assets affects earnings and profits under the tax law only when the increase is realized by disposition, and then only to the extent it is recognized in computing taxable income. IRC §312(f); Regs. §1.312-6(b).

The phrase "reasonable needs of the business," as used in IRC §533, also calls for a specific factual determination. That this is the Congressional intention is particularly clear from the 1969 amendments to IRC §537, which added to the reasonably anticipated needs of the business, two additional items, sec. 303 redemption needs and excess business holdings redemption needs.

Sec. 537 goes on to specify in detail the computation of the §303 and excess business holding amounts. The §303 redemption needs are to be added as such to business needs. There is no basis for denying them or reducing them by reason of corporate liquidity or unrealized increase in market value of assets.

Moreover, Congress has specifically indicated its intent that increased market values of assets are to be considered in connection with §531 only when they are realized as a capital gain. IRC §535(b)(6) provides that the excess of a corporation's net long-term capital gain over its net short-

term capital loss shall be deducted from the corporation's taxable income in computing its "accumulated taxable income." In providing for this deduction, the Conference Committee said (H. Rep. No. 1213, 82d Cong., 1st Sess., 1951-2 CB 622, 629):

> ". . . the fact that such excess is not to be taken into account in the tax basis on which the penalty tax under section 102 [now §531] is imposed will not prevent capital gains from being taken into consideration in determining whether earnings and profits of a corporation have been permitted to accumulate beyond the reasonable needs of the business."

If increased market value of assets, before they become part of earnings and profits by being realized as capital gains, were to be considered in determining whether earnings or profits have accumulated beyond the needs of the business, as the Tax Court below has held, there would be no purpose for a statement by Congress that they should be taken into consideration when they are realized as capital gains.

During the passage of the Revenue Act of 1954, Senate Report No. 1622, 83rd Congress, 2d Session, stated (p. 317):

> "In determining the portion, if any, of the earnings and profits for a taxable year which may be retained for the reasonable needs of the business, the amount of the earnings and profits accumulated in prior years shall, of course, be taken into account."

Again, this indicates that the amount of earnings and profits accumulated in prior years, not the unrealized fair market value of the assets into which those earnings and profits have been placed, is the determining factor in computing the amount of earnings and profits for a taxable year which may be retained.

The operation of the accumulated earnings credit further demonstrates that only earnings and profits, and not unrealized fair market value of assets, are relevant in applying the accumulated earnings tax. IRC §535(c)(2) allows a minimum accumulated earnings credit in any year in the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. For example, if at the end of a year a corporation's earnings and profits accumulated to that date totalled $75,000, but these earnings had been invested in unrelated stocks which then had a fair market value of $500,000 and the corporation could demonstrate reasonable business needs of only $150,000, still no accumulated earnings tax could be imposed on that corporation. We submit that this is a statutory demonstration that the structure of the accumulated earnings tax does not take into account unrealized increase in market value of assets.

Contrary to the Tax Court's decision in this case, three United States District Courts have held that unrealized increment in fair market value of assets is not to be used in determining whether earnings and profits exceeded reasonable business needs. *Ivan Allen Co. v. US* (D Ga. Oct. 6, 1972), 72-2 USTC ¶9735, 30 AFTR 2d 5783; *Harry A. Koch Co. v. Vinal*, 228 F. Supp. 782 (D Neb. 1964); *American Trading & Production Corp. v. US* (D Md. May 10, 1972), 72-1 USTC ¶9432, 29 AFTR 2d 72-1301, (on appeal to CA 4).

The Tax Court in its supplemental opinion herein referred to *Helvering v. National Grocery Co.*, 304 US 282 (1938). That decision supports our view of this matter. Involved there was §104 of the 1928 Act, which still used the phrase "gains or profits." The taxpayer argued that

there were no gains or profits because the depreciation in the market value of the securities owned, none of which were sold, exceeded the net income of the corporation. Referring to this contention, the Supreme Court stated (p. 291):

> "The argument is that the word 'gains' was not used as synonymous with 'profits,' but to express contemplated unrealized increases or accession in net worth of the assets; and that assessability under §104 depends not upon gains or profits — but upon the aggregate of gains (or losses) and profits, since prudent directors would take these into consideration in determining whether a dividend should be declared. Depreciation in any of the assets is evidence to be considered by the Commissioner and the Board in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business. But obviously depreciation in the market value of securities which the corporation continues to hold does not, as matter of law, preclude a finding that the accumulation of the year's profits was in excess of the reasonable needs of the business."

While the Supreme Court indicates that the Commissioner and the Tax Court may take into consideration depreciation in any of the assets and thus hold that the accumulation of earnings and profits was not unreasonable, nevertheless the decision of the Court fundamentally is that legal application of the section involves application of the earnings and profits without consideration of changes in market value of assets. The Court rejected the argument that the word "gains" contemplated unrealized increases in net worth of assets.

In light of the taxpayer's argument in *National Grocery Co.* that the word "gain" included unrealized increase in value of assets, the 1936 Act, changing "gains" to "earnings" and making clear that this applied only to the fund

out of which dividends were payable, becomes even more significant. It seems evident that the *National Grocery Co.* case was pending in the Revenue Service and/or Board of Tax Appeals when this legislation was being considered, since the Board's decision was promulgated December 9, 1936. *National Grocery Co.*, 35 BTA 163. The change in the 1936 Act could well have been for the express purpose of preventing any inference that unrealized increase in market value was to be considered a part of the gains and profits in applying what is now §533.

It is not our position that the amount of liquid assets on a market value basis has no place in any §531 case. On the contrary, where earnings and profits, without unrealized market value, do exceed reasonable business needs so that IRC §533 is applicable, many cases have examined the amount that could be secured by marketing liquid assets to determine whether the corporation was in a position to meet its business needs and to pay dividends from a liquidity standpoint. This is an entirely different matter from adding unrealized increase in market value to earnings and profits in determining whether §533 applies.

In *Faber Cement Block Co.*, 50 TC 317, 328, the Tax Court stated:

> "Essentially what we did in *Nemours* and *Whitney Chain* was to treat the loans to shareholders as 'liquid assets' in the course of determining whether a taxpayer whose accumulated earnings and profits had been found to be beyond its business needs had the necessary wherewithal to pay dividends."

This reasoning has been applied in many cases, in all of which there was first a determination that the accumulated earnings exceeded business needs and then an inquiry as to whether the market value of liquid assets was suffi-

cient to pay dividends. See for example, *Electric Regulator Corp. v. Comr.*, 336 F.2d 339, 344 (2d Cir. 1964); *Novelart Manufacturing Co.*, 52 TC 794 (1969), aff'd 434 F.2d 1011 (6th Cir.), cert. den. 403 US 918 (1971); *Montgomery Co.*, 54 TC 986 (1970); *John P. Scripps Newspapers*, 44 TC 453, 467 (1965); *Ted Bates & Co., Inc., TC* Memo 1965-251, 24 TCM 1346, 1357; *Henry Van Hummell, Inc.*, TC Memo 1964-290, 23 TCM 1765, 1774 (aff'd *Henry Van Hummell Inc. v. Comr.*, 364 F.2d 746 (CA 10).

We submit that the Court below has confused the separate inquiries required in these cases by importing market value into the determination of whether accumulated earnings and profits exceed reasonable business needs, thus attempting to rewrite IRC §533 contrary to its plain language and its legislative and administrative construction. Market value has its place in these cases in determining liquidity only after it is ascertained that §533 applies because earnings and profits exceed business needs.

III. Golconda Had Insufficient Assets to Meet the Business Needs Found by the Tax Court

Even if market value is used Golconda did not have sufficient equivalent of cash assets to meet business needs. The stocks held by the Tax Court to be liquid non-business-related assets included 93,600 shares of Hecla Mining Co., 5,000 shares of Bunker Hill Company and two groups of miscellaneous stocks. The values used by the Court were as listed on the annual report of Golconda for 1966. This report used the December 31, 1966, stock exchange quotation of $43 per share for Hecla, and warned that this market value did not purport to represent the

amount which might be realized upon disposition of the stock (Exh. 27AA).

Using this value, without deduction for capital gain tax or expense or discount on liquidation, the Court arrived at "investment assets currently available for dividend distributions" of $3,755,548, compared to $3,150,000 which it had determined was needed in the business (R. 124).

At the end of 1966, Golconda owned more than 10% of the outstanding stock of Hecla (Exh. 27AA). Also, Golconda's director Magnuson was a director and member of the executive committee of Hecla. For these reasons, Golconda would be considered a controlling person of Hecla under the Securities Act of 1933 and could not sell any substantial amount of the Hecla stock without registration, except by a private placement.* Cf. §§2(11), 4(1) and 5 of the Securities Act of 1933 (15 USC 77b11, 77d and 77e); Securities Regulations, *Loss*, Vol. I, 2d Ed., p. 557, Vol. II, 2d Ed. p. 764 *et seq.* and Vol. V, Supp. of 2d Ed., p. 2700 *et seq.; Selected Problems in Securities Law*, Handbook 17, Practising Law Institute, pp. 9-40; *Controlling Stockholders and Other Insiders*, Handbook 40, Practising Law Institute, pp. 9-52; Practising Law Institute Handbook 38, *How to Go Public*, pp. 425-445.

If a private placement were made, a very substantial discount from market would be involved. The 93,600 shares of Hecla at the market rate of $43 represented a quoted value of more than $4,000,000. A purchaser at private placement would have to commit itself to hold the stock for investment and not for resale. Securities Act Re-

*The quantity of Hecla shares to be sold would exceed the limit of Rules 154 and 162 and of Regulation A promulgated by the Securities and Exchange Commission pursuant to the Securities Act of 1933.

leases 4552 and 5121; Vol. 1, *2d Annual How to Go Public Institute*, Handbook 61, Practising Law Institute, pp. 43-48, 71-78, and material cited therein. To find a purchaser who was willing to be locked into a volatile stock, such a Hecla, with an investment of this order for an indefinite period, would be difficult. We are informed that the discount likely would be in the neighborhood of 25%. Cf. *LeVant v. CIR*, 376 F.2d 434 (CA 7); *William H. Husted*, 47 TC 664.

The other answer would be registration. This would involve getting Hecla to cooperate in filing a registration statement with respect to the stock so as to permit a secondary public offering. Hecla could well refuse on the ground that a secondary offering of this amount of its outstanding stock could severely disrupt the market for its shares.

If Hecla agreed to the registration, the cost would be borne by Golconda. This cost would most likely be $50,000 to $100,000. Cf. Practising Law Institute, Course Handbook Series No. 36, *Going Public Workshop 1970*, p. 168; Winter, *A Complete Guide to Making a Public Stock Offering*, p. 73. The underwriting commission on an offering of this size would be 5% to 10% of the price to the public. Cf. Winter, *supra*, p. 65. This would be a range of $200,000 to $400,000 on four million dollars of stock.

The underwriter would probably have difficulty in marketing on the exchange the amount of registered stock required to be sold. The rules of the SEC would require him to deliver a prospectus to each purchaser. It is a difficult thing on an exchange, such as the New York Stock Exchange, to determine who purchased particular shares. Moreover, the flooding of the market could have disastrous

effects on the price, and the feeding of small quantities into the market would take many months, possibly a year in this situation, to dispose of the stock, leaving the underwriter with his large investment and vulnerable to market changes. So as a practical matter, the underwriter would probably sell the stock outside of the exchange. To do so, he would have to offer a discount from the exchange price. We are informed that this discount normally runs in the area of 10%. This would be in addition to the underwriting commission and the cost of registration.

The excess liquid assets, found by the Tax Court to be $605,548, would evaporate rapidly in marketing the Hecla stock under these conditions. Even discounts and expenses totaling 15% of the value of $4,024,800 attributed by the Tax Court to the "liquid" Hecla shares, would have wiped out this excess.

It is significant in this respect that in determining whether broker-dealers have the required capital, the SEC will not permit them to give any value to securities which cannot be publicly marketed without registration. The SEC classifies such securities as "not readily marketable". SEC Form X-17A; SEC Accounting Release No. 113. An investment company is not allowed to use market quotations in stating the value of such stock. It must reduce the value for the diminution which would be incurred in marketing such stock. SEC Investment Company Act Release No. 5847. The designation by the Tax Court of the Hecla shares as a "liquid asset" at full market quotation is improper under these circumstances.

Even ignoring the problems of control stock, Golconda urged in the Tax Court that capital gains tax and ordinary

brokerage would substantially wipe out the excess liquid assets found by the Court. The Tax Court rejected this argument on the ground that it would be impossible to calculate the tax (R. 194).* However, it is possible to compute the *least* amount of tax that would be paid, by allocating to the 93,600 shares of Hecla stock, held by the Tax Court to be a liquid non-business asset, the highest possible cost base. Schedule A of Appendix B, pp. A-5-6, shows this allocation, and Schedule B of Appendix B, p. A-7, uses this cost base in showing that if the stocks classified as "liquid" by the Tax Court were sold at the end of 1966 at full quoted prices, capital gain tax and ordinary New York Stock Exchange brokerage commissions would have reduced the excess liquid assets found by the Court at least to $45,353.92.

It is obvious, we believe, that the realization would have been much less than this. To take smaller items first, the brokerage costs on the unlisted stocks would have been substantially higher than the stock exchange rate. Also, the market for those stocks would be very thin, and to liquidate them rapidly would drive the price down. Moreover, even if the secondary offering requirements caused by the control position of Golconda were ignored, the size of the block of Hecla stock to be liquidated would cause blockage problems. The Wall Street Journal shows an average of 3,200 shares of Hecla per day traded on the New York Stock Exchange during the last week of December, 1966. To sell 93,600 shares on that market would either

*It is interesting to note that the Department of Justice conceded the deductibility of capital gains tax and 6% brokerage cost (compared to 1% used in Schedule B of Appendix B, *infra*) in its brief filed in *Ivan Allen Co. v. US* (D Ga. Oct. 6, 1972), 72-2 USTC ¶9735, 30 AFTR 2d 5783.

drive down the price or take a very long time. If the long time were taken, the realization would be subject to the hazard of market fluctuation.

Golconda offered in the Tax Court to introduce evidence supporting the discounts and costs that would be involved in converting the Hecla stock into cash at the end of 1966 (R. 151-152, 156-160). The Tax Court rejected this offer on the ground that Golconda would not have needed all this cash at the end of 1966 but only over a period of years as the new exploration proceeded, and thus Golconda could have sold the stock gradually over many years on the market. (Tax Court Supplemental Opinion, pp. 8-9, R. 195-196; 58 TC No. 74). We submit that in so holding, the Tax Court erred on several fundamental grounds.

The first is that the Tax Court here imposed the tax on the ground that Golconda had investment assets "currently available" for reasonable business needs and dividend distributions (R. 124) and that these were "liquid assets" (R. 123). Assets are not liquid assets currently available for business needs and dividends except to the extent that they can currently be converted into cash.

Secondly, there is nothing in the record to justify the Tax Court in its assumption that the market value of the Hecla stock would remain constant over the long period of years of the new mining exploration so that the stock could be liquidated gradually and meet the business needs. The Hecla stock is at the time this brief is being written (December 20, 1972) at 14⅞. Adjusting for the 2-for-1 split in 1968, this would be equivalent to a price of $29.75 for the Hecla shares held by the Tax Court to be liquid

assets, compared to the price of $43 per share used by the Tax Court.

Certainly the directors of Golconda at the end of 1966 could not have had any confidence that the Hecla stock could have been sold over a long period of years with a net realization of $43 per share. The Hecla stock in 1966 went from 27⅜ up to 52⅞, back to 35⅝ and then up to $43 at the end of 1966. To force the directors of a public company to distribute assets in dividends on the assumption that a volatile stock such as this could be sold piecemeal over many years at a net realization higher than could be secured by an immediate liquidation, would be to attribute to Congress an intention to require directors to gamble on the future of the stock market. It is difficult to conceive of a further departure from the spirit and intent of the accumulated earnings tax.

Furthermore, the Tax Court was under a misapprehension that registration under the Securities Act would not have been required if Golconda, as a controlling person, had followed a plan to liquidate the stock by selling partial amounts annually over a period of years. The SEC would have classified such a program as a distribution requiring registration. Securities Act Release 4818 (1966) 3.

Moreover, the reduction in realization caused by capital gains tax and brokerage would not be avoided by piecemeal liquidation, and the Revenue Act of 1969 raised the capital gain rate to 28% for years after December 31, 1969, and 30% for years commencing January 1, 1971. IRC §1201. Also after 1969, capital gains were included in tax preferences subject to an additional 10% tax. IRC §§56-58. If there were any doubt that the assets labeled as liquid

by the Tax Court could not have been liquidated for sufficient cash to meet reasonable business needs, even at the quoted values used by the Tax Court, this higher rate would dispel it. Schedule B of Appendix B, p. A-7, uses a 25% capital gain rate. An additional 5% tax would be $102,825 on the minimum gain there projected, and an additional 15% tax would be $308,476. This continuing power of Congress to change tax rates is another factor demonstrating the impropriety of using any values other than the actual cash realization that could have been secured at the end of the year involved in a §531 case.

We submit that the only proper and practical answer to the application of IRC §531 et seq. in this situation, if the statutory test of earnings and profits were to be abandoned for a test of unrealized liquid market value, is that the actual cash that could be secured from the investments at the end of the year involved should be the basis for determining how much was available for business needs and dividends. At the end of 1966, Golconda could not have disposed of the stock, held by the Tax Court to be liquid nonbusiness assets, for enough net realization to have met the reasonable business needs found by the Tax Court.

IV. All Hecla Stock Was Held for Business Purpose

While the Tax Court held that the Hecla stock owned by Golconda representing Golconda's original interest in Lucky Friday was a business asset not required to be sold to pay dividends, the Court held that the additional Hecla stock purchased by Golconda was not a business asset. We submit that the circumstances establish the contrary.

Although the Tax Court stated (R. 74) that Hecla took over control of Lucky Friday in January, 1959, actually it was December, 1958 (Tr. 103, 491, 613). The Tax Court further found that immediately after Hecla gained control of Lucky Friday, Golconda initiated a program of acquiring Hecla stock (R. 90). The first purchases were in December, 1958, when 3,000 shares were purchased at a cost of $32,432.98 (R. 91; Exh. 110).

It is most significant that the first purchase of Hecla stock was made immediately upon Hecla's taking control of Lucky Friday. One may well ask, if this purchase were simply an investment unrelated to any business objective growing out of the Hecla take-over, why was the investment made at this particular time in this particular security? This question is especially pertinent in light of the fact that Golconda had a large surplus deficit and had not been making any unrelated investments.

The answer is, of course, that the purchases of Hecla stock were related to the Hecla take-over of Lucky Friday and were not an unrelated investment. The purpose of the purchases of Hecla stock was set forth contemporaneously in the minutes of the directors' meetings of Golconda on March 10, 1959, and November 9, 1960, quoted in the Appendix D, p. A-11. That purpose was to protect Golconda's interest in Lucky Friday.

The Tax Court states that Golconda's original interest in Lucky Friday had come from advancing funds to Lucky Friday (R. 73). Actually, there was more to it than that. The stock came to Golconda not only for money advanced, but also as reimbursement for mining development work done by Golconda on the Lucky Friday property (Appendix C, p. A-10) By 1958, Golconda had, through its own efforts, developed Lucky Friday from nothing until it was on the verge of being one of the leading silver mines in the United States.

It is not believable that IRC §531 was intended to require Golconda to dispose of its interest in this mine, on the verge of success, just because another corporation had seized control. Likewise, it is not believable that §531 was intended to prevent the directors of Golconda from taking steps to protect that interest in light of the take-over by Hecla.

Lester Randall, president of Hecla, called as a witness for the Commissioner in this case, testified that on July 22, 1960, Magnuson went on the Hecla board of directors representing Golconda because Golconda had become a major shareholder in Hecla (Tr. 779-780). Thus, the first step in accomplishing the purpose of these purchases of Hecla stock had been achieved, i.e., Golconda now had a voice in determining Hecla's policies concerning Lucky Friday.

If even the 37,000 shares of Hecla purchased through 1960 had been held to be business assets, there could have been no finding by the Tax Court that the value of investment assets exceeded business needs. Beyond this, however, we submit that the later purchases of Hecla stock also were business-related. The hazard of termination of dividends continued through 1966 and thereafter, as witness the actual termination of dividends by Hecla in 1970. Moreover, the 1966 purchases of Hecla stock were made to facilitate the proposed merger, as well as to solidify Golconda's influence on Hecla policies. The merger, we sub-

mit, was a business purpose of Golconda. See discussion in part VI, *infra*.

We submit that the Tax Court erred in holding that only 230,000 shares of Hecla stock were held for a business purpose and that, on this point alone, the Tax Court erred in finding that the equivalent of cash assets in 1966 exceeded the reasonable needs of the business.

V. Golconda Was Entitled to Accumulate Funds Sufficient for the Exploration

In arriving at reasonable business needs, the Tax Court held that Golconda was allowed to accumulate only $2,500,000 for the new mining exploration, even though the cost would be greater. We submit that the Tax Court erred in so holding.

There is no question here that from the time it lost control of the Lucky Friday mine, Golconda was actively and energetically pursuing the development of a new deep-mining venture. The Tax Court held that the record was replete with evidence of this (R. 119).

While the cost of this exploration was estimated by Featherstone in 1959 at $3,500,000, the actual costs being faced in 1966 are shown by the testimony of Kesten, chief geologist of American Smelting to be between $7,000,000 and $10,000,000. Moreover, Randall, president of Hecla, estimated the cost of the Golconda project itself at $6,000,000 (Tr. 809).

In allowing $2,500,000 for this exploration, the Tax Court used a total cost of $3,500,000. We submit that the evidence conclusively established that by 1966 this figure of $3,500,000 was far too low. The Tax Court should have

found that in 1966 the cost would have been reasonably forecast at $6,000,000 to $10,000,000. Even if Golconda were not to be allowed to accumulate sufficient funds to pay for the entire exploration, nevertheless the Tax Court, under its own theory, should have allowed at least $5,000,000 to be accumulated by Golconda.

Even more fundamental, however, is the definite possibility that Golconda would do the exploration alone. In 1959, with Golconda's only source of income being Lucky Friday dividends, and with Golconda still having an earned surplus deficit, it is little wonder that, as the Tax Court mentioned (R. 121), Golconda's directors felt that Golconda should not undertake the entire financial risk of the new exploration. Nevertheless, as the years went on and Golconda plowed more and more time and money into the new project and developed additional finances, there was certainly no decision that Golconda would not carry on the project itself if need be.

Featherstone, Golconda's president, was a mining engineer with a lifetime of experience in the area. Golconda had previously operated two mines and had carried the Lucky Friday mine to great depth before the Hecla takeover. Golconda thus was able to take on and carry out the full exploration, given sufficient finances.

That the possibility of its so doing was contemplated by Golconda is shown by the record here. In its registration statement filed with the SEC on March 3, 1966, Golconda stated (Exh. 55BC pp. 2889-29 and 30):

> "The Registrant's acquisition of the securities of companies owning property in the 'Golconda Area' have not been acquired in a strict sense as an investment.

The acquisition of the securities of these companies, as well as the acquisition of mining properties in fee by the Registrant, has been as part of a consolidation program directed toward exploration and development of the mining properties in the Golconda Area, which in total comprises 3,630 acres of land. The Registrant has had a geologic study made of the Golconda Area which indicates mineralized zones worthy of such exploration and development.

"After the necessary unitization or consolidation of the Golconda Area has been completed, the Registrant intends to undertake such exploration and development program either by itself or in conjunction with one or more other major mining companies or by means of a corporate reorganization. If and to the extent that the Registrant does not have sufficient funds to effect such exploration and development program, Registrant's earnings may be retained and used for such purposes."

By the end of 1966, Golconda had acquired $1,000,000 worth of land or interests therein for the new exploration (R. 124) but had not yet secured a partner. It faced the situation where if it found no partner, it would have to proceed by itself or drop the project. With that much land acquired and with a favorable feasibility report from Shenon & Full, a leading firm of independent geologists, it is not likely that Golconda would drop the project.

Moreover, even if it were to find a partner after 1966, there would be no assurance that the partner would carry the project through. A development contract was finally negotiated with Hecla in 1969. Under that agreement, Hecla was obligated to build a surface plant estimated to cost $500,000 to $750,000 (Tr. 807-808). At all times thereafter, even prior to sinking any shaft, Hecla could abandon the project (Tr. 808; Exh. 69 BQ Art. XVIII), in

which case Golconda would be faced with the decision as to whether to carry it on itself. A decision by Hecla not to proceed with the project could well have nothing to do with the merits of the project. It could arise from the same sort of working capital pinch as the Lakeshore transaction, which Hecla entered into with El Paso Natural Gas Co., which caused Hecla to cease paying dividends in 1970 (Tr. 554, 802; Exhs. 30AD, 31AE, 2d Series, p. 84).

Consequently in 1966, there was the very real possibility that Golconda would proceed with the exploration entirely at its own cost. Nevertheless, the Tax Court has held that in this situation the federal income tax law did not permit Golconda to accumulate the funds so that it could do so if that eventually developed. This decision is incorrect. Cf. *Templeton Coal Co., Inc. v. U.S.*, 301 F. Supp. 592 (S.D. Indiana, 1969).

When the magnitude of the financial requirements and risks facing Golconda is considered, the possible additional personal taxes of $7,676.77 on all of the five directors together, which might have been paid if all earnings were distributed in 1966 necessary to eliminate any possibility of §531 tax, is *de minimis* and is no evidence of purpose to avoid tax.

We submit that Golconda was entitled to accumulate sufficient assets to accomplish the mining exploration itself. Moreover, the cost of the exploration that could be anticipated at the end of 1966 was more in the nature of $6,000,000 to $10,000,000 than the figure of $3,500,000. Thus, even if one were to accept the Tax Court's theory that Golconda was not to be allowed to accumulate the entire cost, it should have allowed at least $5,000,000. In

either event, there was no excess accumulation of earnings by Golconda.

VI. Redemption of Golconda Stock in 1966 was for Business Purpose

During 1966, Golconda purchased 67,000 shares of its own stock at a cost of $485,600 (Exh. 27AA). The Tax Court concluded that this purchase was primarily to reduce the number of shares which would have been required to be issued by Hecla in connection with the contemplated merger, which the Tax Court regarded as a stockholder, not a business, purpose and as evidence of a surplus of funds (R. 126). We submit that the Tax Court was in error.

The merger negotiations with Hecla were a part of Golconda's attempt to find a partner for the deep exploration of the Golconda area (Tr. 517-518; Exh. 55BC p. 30; cf. the SEC registration statement previously quoted). As a means of carrying out a joint exploration of this magnitude, a merger had advantages over an exploration agreement, since a merger avoided conflict in allocations of costs, programs of exploration to be carried out, timing of the work, etc. (Tr. 517).

The year 1966 was the high point in these negotiations. At this very time, William Graham, Jr., of David A. Noyes & Co., the largest stockholder in Golconda (probably controlling 22% of the stock, Tr. 545-574), started dumping his stock (Tr. 667; Exh. 134).

Two key factors in the merger negotiations were the market value of Golconda's stock and the number of net shares of Hecla stock (after offsetting the large number of Hecla shares owned by Golconda) that would have to be

issued in the merger (Exhs. 87CI, 92CN, 93CO, 131, 132 Tr. 347-348, 667). Graham was muddying up the works. Consequently, it was to Golconda's advantage, in view of all of these factors, to purchase its own stock (Tr. 667).

Since a basic objective of the merger was to bring about development, on the best possible basis, of the properties which Golconda had put together, the efforts for the merger and the purchase of Golconda stock to facilitate it were business activities. Moreover, it was necessary to get rid of the objecting stockholder with the least possible adverse effect on Golconda's position. Graham was alienating Hecla, which was the logical partner for Golconda in the exploration, and thus threatening the future development of the Golconda property, whether done through merger or through development agreement.

Purchase of stock to eliminate a dissenting shareholder, who is interfering with the carrying out of management decisions, is a business purpose and does not indicate an excess of funds in applying the accumulated earnings tax. This is particularly true where the funds were being accumulated for a business program and were used for the stock purchase because of an exigency. *Penn Needle Art Co.*, 17 TCM 504, 1958 PH TC Memo ¶58,099; *Farmers & Merchants Investment Co.*, 29 TCM 705, 711, 1970 PH TC Memo ¶70,161; *Gazette Pub. Co. v. Self*, 103 F. Supp. 779 (DCED Ark. 1952). Cf. *Faber Cement Block Co.*, 50 TC 317, 335 (1968); *Fred F. Fischer*, 6 TCM 520, 1947 PH TC Memo ¶47,131.

CONCLUSION

This case presents a far cry from the incorporated family pocketbook which Congress sought to reach in adopting the accumulated earnings tax.

Here is a public corporation for which its directors, with small stock interest of their own, were conscientiously and energetically attempting to get another well-conceived mine started after the operation of its two mines was lost through no fault of its own. Along with this, they demonstrated a desire to pay dividends at a regular, increasing basis, commencing even when there were no earnings. Millions of dollars and great risks were involved, both in the development program and in the protection of Golconda's original interest in Lucky Friday. It would be difficult, we believe, for any able, top-notch business executive to testify that he would have made dividend decisions different from those made by Golconda were he in the same situation.

The Tax Court held that Harry Magnuson dominated the company because of his personality, his position as an officer and director, and his 5% to 10% stock interest. May we suggest that a large percentage of the publicly-held corporations in this country have a similarly strong personality influential in their management, with similar minor stock interests. Hence, the decision below threatens accumulated earnings tax against a substantial spectrum of the nation's publicly-held corporations in spite of the fact that Congressional action has shown that it believed that these corporations were not to be taxed under §531.

The decision below, imposing §531 tax for 1966, should be reversed.

Respectfully submitted,

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APPENDIX A

Statutes Involved

IRC 1954 (1966 edition):

§ 531. Imposition of accumulated earnings tax

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

§ 532. Corporations subject to accumulated earnings tax

(a) General rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

(2) a foreign personal holding company (as defined in section 552), or

(3) a corporation exempt from tax under subchapter F (section 501 and following).

§ 533. Evidence of purpose to avoid income tax

(a) Unreasonable accumulation determinative of purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumu-

late beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) Holding or investment company.—The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders.

§ 535. Accumulated taxable income

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to taxable income.—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164(b) (6)), accrued during the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) Charitable contributions.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to the limitation in section 170(b)(2).

(3) Special deductions disallowed.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) Long-term capital gains.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taxable income.

(7) Capital loss carryover.—No allowance shall be made for the capital loss carryover provided in section 1212.

(8) Bank affiliates.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(c) Accumulated earnings credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by

which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $60,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) Cross reference.—

For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551.

§ 537. Reasonable needs of the business

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

APPENDIX B

SCHEDULE A

Computation of Highest Cost Base Which Could be Attributed to 93,600 Shares of Hecla Stock

There is no way to tell which particular certificates of Hecla stock would be sold by Golconda if it disposed of stock for payment of dividends or for business needs. Nevertheless, we can ascertain the lowest capital gain tax that could be imposed on such sale, by ascertaining the highest cost base that could be attributed to any stock that could be sold. This can be done by allocating to the 230,000 shares, held by the Tax Court to be business-related, the lowest cost base possible for that number of shares, allocating the higher cost base stock to the shares that the Tax Court held should be sold.

The lowest cost base is the $20,257 cost of the 203,850 shares received by Golconda for original Lucky Friday shares in the merger (Exh. 110). This leaves 26,150 shares of Hecla, purchased by Golconda, to make up the 230,000 business-related shares. The analysis below shows that the lowest cost base for 26,150 shares, among the Hecla shares purchased, totaled $226,692.88. Adding this to the $20,257 cost of the 203,840 shares, gives a total of $206,435.88 as the lowest cost base that could be attributed to the 230,000 shares held by the Tax Court to be business-related. Deducting this amount from the total cost base of $2,123,-134.57 for all Hecla stock held at the end of 1966 (Exh. 110) leaves $1,917,298.69 as the highest cost base that could be attributed to the 93,600 shares of Hecla which the Tax Court held to be liquid assets.

Purchases of Hecla Stock Having Lowest Cost Base for 26,150 Shares (Taken from Exhibit 110)

Date	Shares	Price Per Share	Total
7/1960	1,400	$7.9357	$ 11,110.00
8/1960	500	8.	4,000.00
10/1960	200	8.	1,600.00
5/1960	200	8.1500	1,630.00
3/1959	500	8.1897	4,094.88
4/1960	4,300	8.3418	35,870.00
9/1959	3,200	8.6162	27,572.00
2/1960	300	8.7500	2,625.00
6/1959	1,500	8.7860	13,179.00
3/1960	1,000	8.7950	8,795.00
11/1959	4,100	8.8312	36,208.00
10/1959	7,700	8.9297	68,759.00
5/1959	300	9.	2,700.00
1/1960	900	9.	8,100.00
12/1960	50	9.	450.00
	26,150		$226,692.88

SCHEDULE B

Estimate of Cash Realization from Stock (Held by Tax Court to Be Unrelated Liquid Assets) After Capital Gains Tax and Ordinary Brokers' Commissions, Assuming Sale at the Full Quoted Market Price on December 31, 1966

	Cost	Sale Price per Exh. 109	Capital Gain	Tax at 25%	Net Realization
(Exh. 110):					
Total Cost 323,600 shares Hecla.....$2,123,734.57					
Lowest cost base possible for 230,000 shares..... 206,435.88					
Highest cost base possible for 93,600 shares.....	$1,917,298.69	$4,024,800.00			
(Exh. 109): 5,000 shares Bunker Hill.....	46,665.00	131,250.00			
(Exh. 109): Other stocks held by Tax Court to be equivalent of cash (last two groups on Exh. 109 for 1966).....	540,003.00	450,498.00			
		4,606,548.00			
Less brokerage commission (estimated at average of 1%).....		46,065.00			
	2,503,966.69	4,560,483.00	$2,056,516.31	$514,129.08	$4,046,353.92
Provision for corporate liabilities.....					851,000.00
Net available for future needs.....					3,195,353.92
Future needs per Tax Court.....					3,150,000.00
Excess.....					$ 45,353.92

SCHEDULE D

Summary of Income, Capital Gains, Dividends and Retained Earnings, Prepared from the Revenue Agents' 90-Day Letters and from Exhibits 6F through 27AA. These Figures Include Adjustments Made by the Revenue Agents

Year	(1) Net Income	(2) Capital Gains after Tax Included in (1)	(3) Net Income Less Capital Gains	(4) Dividend Paid	(5) Retained Earnings
1960	$ 92,740	$ None	$ 92,740	$ 40,000	$ (24,213)
1961	185,464	43,364	142,100	40,000	121,251
1962	523,972	319,131	204,841	80,000	565,223
1963	507,935	252,946	254,989	80,000	993,158
1964	477,689	103,411	374,278	100,000	1,370,847
1965	408,662	154,962	253,700	140,000	1,639,509
1966	1,000,523	736,204	264,319	176,490	2,463,542

APPENDIX C

Three agreements were worked out. First was an option agreement dated October 18, 1940, whereunder Golconda purchased 100,000 shares of Lucky Friday stock at 10c per share (Exh. 116). This money helped pay off the original option on the property (Tr. 92). Second was the "First Development Agreement" dated January 2, 1942, issuing 15,000 shares of Lucky Friday stock to Golconda for expenditures Golconda had made on the property in addition to the amounts agreed on in the option agreement. This agreement specified certain further development work which Golconda agreed to perform and required that the work be performed by or under the immediate direction and supervision of Golconda and at Golconda's cost and expense, and further required cash advances to Lucky Friday in order that Lucky Friday could meet the payments on the property. Golconda was to receive 125,000 shares of stock for this development work and, in addition, was to reimburse itself insofar as possible for its expenditures out of the proceeds from the sale of ore extracted (Exh. 116). Third was a "Second Development Agreement" dated March 22, 1943, providing for a continuation of the development work by Golconda, and this work was paid for by the issuance of Lucky Friday stock in 1944 (Exh. 116).

APPENDIX D

The minutes of the directors' meeting of Golconda on March 10, 1959, state (Exh. 31AE p. 98):

> "The recent acquisition of controlling interest of Lucky Friday Silver-Lead Mines Corporation by Hecla Mining Company was discussed at length. H. F. Magnuson reported that he and Wray Featherstone had had considerable discussions concerning this acquisition as it related to Golconda's substantial interest in Lucky Friday. He reported that in behalf of Golconda approximately 7,000 shares of Hecla stock had been acquired by Golconda in order to protect its large interest in Lucky Friday. This action was approved by the other directors and after further discussion Walter Sly moved that H. F. Magnuson and Wray Featherstone be authorized to purchase for Golconda 8,000 more shares of Hecla stock at prices deemed to be favorable in the judgment of Mr. Magnuson and Mr. Featherstone. The motion was seconded by C. E. Bloom and upon being put to a vote passed unanimously."

The minutes of the directors' meeting of Golconda on November 9, 1960, state (Exh. 31AE p. 109):

> "Mr. Magnuson then reported that Hecla Mining Company earnings were good and that Golconda's investment in Hecla appears to be sound as it solidifies Golconda's position in Lucky Friday. He stated that this is especially true as the Hecla Board controls the Lucky Friday and makes the major decisions concerning Lucky Friday."